Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global economic activity is strengthening, but inflation stays subdued
- Fed continues to tighten, but market very much doubts its guidance on future rate hikes. ECB reaffirms that rates will remain very low, though QE likely to be wound down next year
- Dollar loses ground as markets doubt Fed will raise rates much further and Trump's pro-growth policies are long-fingered, with political controversies in US also weighing on currency
- Euro in the ascendancy as political concerns abate and Eurozone economy picks up
- Sterling gains ground against weakening dollar, but struggles versus buoyed up euro. Progress on Brexit talks likely to be key factor influencing UK currency in months ahead

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Global Economic Outlook

Firming of global economic activity, but inflation remains very subdued

The IMF and OECD, in their recently published mid-year Economic Updates, both note that global economic activity has firmed, helped by an improvement in investment, manufacturing and trade. Activity started to gain momentum in the second half of 2016, especially in advanced economies, with stronger growth performances in the US, Eurozone, UK and Japan. The OECD expects growth in the world economy to accelerate from 3.0% in 2016, its lowest rate since 2009, to 3.5% in 2017 and 3.6% in 2018, with the IMF also forecasting the same growth for 2017/18.

The IMF sees advanced economies growing by around 2% this year and next, up from 1.7% in 2016, helped by continuing very loose monetary policies and a more supportive stance to fiscal policy. It notes, though, that growth in the US and UK was weaker than expected in H1 2017, but this was offset by stronger than anticipated growth in the Eurozone, Japan and Canada.

Growth did strengthen in the US in the second quarter, but growth forecasts for 2018 have been scaled back significantly on the view that fiscal policy will now be much less expansionary than previously assumed. Nonetheless, GDP growth in the US is still forecast by the IMF to average a solid 2.1% in both 2017 and 2018. By contrast, the strong performance of the Eurozone economy has seen its GDP forecasts revised up to around 2% for this year. There was a marked slowdown in UK growth in H1 2017 as rising inflation and concerns over Brexit weighed on activity. The IMF sees GDP growth in the UK at 1.7% in 2017 and 1.5% in 2018.

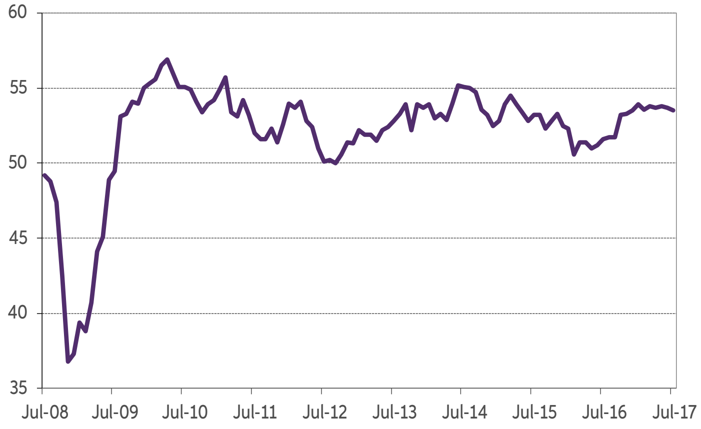
Meanwhile, growth in emerging economies lost considerable momentum in the first half of this decade, slowing from 7.5% in 2010 to near 4% by 2015/16. However, growth in developing economies is forecast to strengthen to 4.6% in 2017 and 4.8% in 2018 by both the IMF and OECD, helped by a moderate recovery in commodity prices and the emergence of oil-producing countries like Brazil, Russia and Nigeria from deep recessions. Activity is also being supported by investment in infrastructure, more expansionary fiscal policies and improving world trade.

Survey data have also been pointing to stronger activity in most economies this year. Notably, the Global Composite PMI has been very steady, averaging 53.7 in the first six months of 2017, consistent with solid growth by the world economy. Labour market data have been particularly encouraging across the main economies, with good jobs growth nearly everywhere, a steady downward trend in Eurozone unemployment and economies like the US, UK and Japan now close to full employment. The unemployment rate in the US has fallen to 4.3% and it stands at 4.5% in the UK.

Downside risks, though, persist for the world economy, especially over the medium term. High private sector debt levels and a reliance on capital inflows represent risks to the growth prospects for emerging economies. Increases in US interest rates could also yet negatively impact global financial markets, where valuations looks stretched with very low bond yields and stock markets rising to elevated levels amidst unusually low volatility. The IMF warns about the risk of a market correction that could dampen global economic growth and confidence.

Meantime, despite the pick-up in global growth, inflation in advanced economies remains subdued and below targets, while it is declining in some emerging economies. Sluggish wage growth and quite low oil prices suggest that inflation is likely to remain subdued in H2 2017 and 2018.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2015	2016	2017 (f)	2018 (f)
World	3.4	3.2	3.5	3.6
Advanced Economies	2.1	1.7	2.0	1.9
US	2.6	1.6	2.1	2.1
Eurozone	2.0	1.8	1.9	1.7
UK	2.2	1.8	1.7	1.5
Japan	1.1	1.0	1.3	0.6
Emerging Economies	4.3	4.3	4.6	4.8
China	6.9	6.7	6.7	6.4
India	8.0	7.1	7.2	7.7
World Trade Growth (%)	2.6	2.3	4.0	3.9
Advanced Economies Inflation (%)	0.3	0.8	1.9	1.8

Source: IMF World Economic Outlook (Update), July 2017

Interest Rate Outlook

Markets doubt Fed tightening path, while ECB policy to remain very accommodative

The past number of years have been characterised by a widespread loosening of monetary policy in many countries and a scaling back of rate hike expectations in economies where policy tightening had been expected to commence. The era of monetary easing, though, appears to be coming to an end. The US Federal Reserve has embarked on a path towards policy normalisation, with rates also being hiked in Canada and the Czech Republic in the past month. Nonetheless, monetary policy is set to remain exceptionally loose in most economies.

In the UK, inflation picked up following the sharp decline in sterling last year, with headline CPI inflation expected to hit 3%. The BoE has been indicating that there are limits to the extent that above-target inflation can be tolerated, with some MPC members voting for a rate hike at recent meetings. The majority on the MPC, though, want to wait and see if the slowdown in activity so far this year is sustained or not, so an increase in rates does not look imminent. The market is pricing in two 25bps rate hikes by mid-2020. The course of the Brexit negotiations could well be a key factor in rate decisions. A 'soft' Brexit could see rates rise by more than the 50bps priced in by markets over the next three years. By contrast, rate increases would seem unlikely if a 'hard' Brexit unfolds.

Meantime, the ECB has indicated that it will continue with its QE programme until at least the end of 2017, although it has scaled back its easing bias by no longer committing to lowering rates even further if required. However, it continues to indicate that it could expand its QE programme further if necessary. The expectation in markets, though, is that the ECB will taper its QE programme next year. Meanwhile, the ECB expects to keep interest rates at their current very low levels well past the time horizon of its QE programme.

The ECB deposit rate stands at –0.4% and it is likely to be late 2018 or early 2019 at the earliest before this is increased, given the guidance from the Central Bank on QE and rates. Futures contracts show that wholesale rates are expected to start edging modestly higher next year, with three month money rates remaining negative until H2 2019. Eurozone rates are expected to remain very low for a long period of time after that, with futures contracts suggesting that three month rates will not reach 1% until end 2022.

Meanwhile, after raising rates by 25bps to 0.375% at its December 2015 meeting, the first such rate hike in nearly a decade, the US Federal Reserve refrained from any further rate hikes, until it implemented a second 25bps increase in December 2016. However, it has followed this up with two further hikes in March and June of this year, taking rates up to 1.125% and has indicated that it is likely to hike rates again to 1.375% before year end.

At its June meeting, the FOMC reaffirmed its interest rate projections showing that it expects to raise rates to 3% by end 2019. Markets, though, see rates rising to just 1.75% by then, far below the Fed's projections. Furthermore, the Fed also indicated at its July meeting that it will start to unwind its asset purchase programme, or QE, "relatively soon", thereby reducing the size of its balance sheet, albeit at a very slow pace. An announcement on the start of this process could well come at the September FOMC meeting.

While inflationary pressures remain subdued in the US, we expect solid growth and a tight labour market will see the Fed tighten policy by more than markets expect, with the next rate hike likely at end year. However, with inflation running below target, rates may not rise as quickly as projected by the Fed in 2018/19. We see the Fed funds rate rising by 50bps in each of the next two years, taking it up to 2.375% by end 2019.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.125	1.31	1.73	1.60	1.88
Sept '17	1.125	1.35	1.80	1.65	1..95
Dec '17	1.375	1.60	2.05	1.90	2.20
Mar '18	1.625	1.80	2.25	2.10	2.40

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.37	-0.19	-0.16	0.24
Sept '17	-0.40	-0.35	-0.15	-0.12	0.28
Dec '17	-0.40	-0.33	-0.10	-0.07	0.35
Mar '18	-0.40	-0.30	-0.05	0.00	0.40

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.25	0.28	0.60	0.57	0.83
Sept '17	0.25	0.28	0.60	0.60	0.85
Dec '17	0.25	0.30	0.63	0.65	0.90
Mar '18	0.25	0.30	0.65	0.70	1.00

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Euro surges as dollar loses its shine

A key development in forex markets in the past month has been that the euro has moved out of its relatively narrow trading range of $1.04-1.16 against the US dollar that it had occupied since early 2015. In the first half of this year, the euro made impressive gains against the dollar, climbing from $1.04 to above the $1.14 level, despite further rate hikes by the Fed in March and June. The euro rally against the weakening dollar has gained further momentum in recent weeks, as it climbed to near $1.19, it highest level since January 2015.

Developments in Europe have helped the euro to gain ground. Eurozone growth has picked up appreciably in the past three quarters, with the jobless rate moving steadily lower. This has seen the ECB row back on its easing bias, in particular dropping references that it could lower rates further. Markets now expect three month money rates in the Eurozone to turn positive by autumn 2019, compared to mid-2021 last year. There is also a growing expectation in markets that the ECB will taper QE, or wind down its asset purchases, next year.

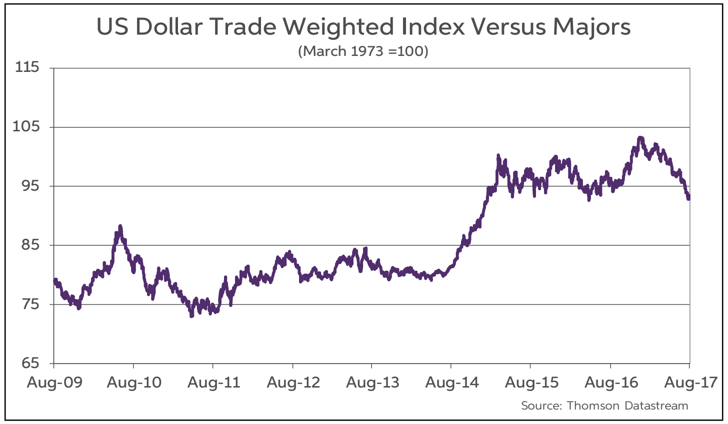
Abating political risks have also helped the euro, with far-right and euro-sceptic political parties not doing particularly well in European elections this year, most notably in France. By contrast, political risks are growing in the US, with the Trump administration embroiled in one controversy after another. Markets are also becoming very doubtful about whether President Trump will be able to implement any of his planned expansionary fiscal agenda. This has seen a scaling back of growth forecasts for the US economy in recent months.

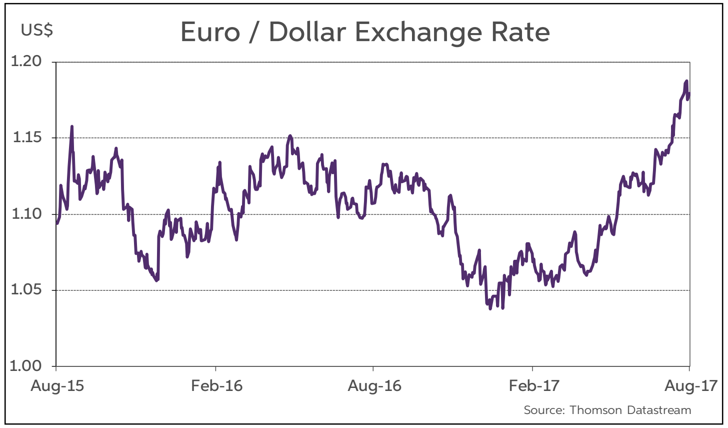
The dollar has lost ground against a broad range of currencies over the summer months and not just the euro. The Aussie, NZ and Canadian dollars have risen to their highest levels against the US currency in over two years. Even the Chinese yuan, which declined steadily against the dollar over the 2014-16 period, has appreciated against the greenback in recent months, while sterling has risen to above the $1.30 level from $1.22 in the spring. Overall, the dollar has fallen by 10.5% on a trade-weighted basis year-to-date, including a 5% fall since late June.

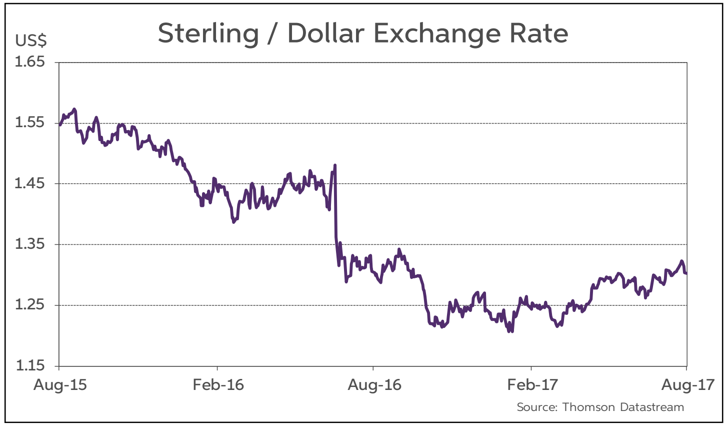
Reuters reports that the dollar's decline has been exacerbated by leveraged bets in recent weeks as funds borrow in the US currency to invest in global assets. Broad market positioning data show that short bets against the dollar have risen to their highest level since early 2013. Another issue for the dollar is that markets simply don't believe Fed projections that US rates are on a steady tightening path that will take them up to 3% by late 2019. Furthermore, indications from the Fed that it is likely to start reducing the size of its balance sheet "relatively soon" as it begins unwinding its QE programme has not provided any support for the dollar.

For the dollar to regain its mojo, it will likely need both monetary and fiscal policy to play a role. However, the prospect of a near-term fiscal stimulus from the Trump administration has diminished, while it could be well into next year before it becomes clear if the market is underestimating the extent of Fed tightening. Thus, the dollar could remain on the defensive in the weeks ahead, with the EUR/USD testing the key $1.20 level.

This does not mean that all is lost for the dollar as the Fed could surprise markets with the extent of its policy tightening, while progress on implementing Trump's fiscal agenda could be made next year ahead of mid-term Congressional elections. In particular, a one-off large cut to corporate tax to entice back profits held by US corporates overseas would trigger renewed dollar gains, especially given the market's short dollar positioning. Thus, there may be scope for the dollar to regain some ground later this year and in 2018.







Forex Market Outlook

AIB Treasury Economic Research Unit

Brexit to remain key factor impacting sterling

Sterling fell sharply last year on concerns over Brexit. The currency hit 30-year lows against a strong dollar, falling from above $1.50 to around the $1.20 level. The euro made significant gains against sterling too, with the EUR/GBP rising above 90p last autumn, up from 70p near the end of 2015.

Sterling, though, did find a trough in the late autumn and managed to regain some ground at end 2016. This saw the euro drop back to around 84p. However, the euro has been in the ascendancy this year on currency markets. Meanwhile, the snap UK general election, which saw the Conservative Party lose its majority in Parliament, brought renewed pressure on sterling. Thus, the euro has been on a steady upward path against sterling over the last three months, climbing from 84p to back up above the 90p level. On the other hand, sterling has been on a general upward trajectory against the weakening dollar this year, moving back above the $1.30 level in recent weeks. Thus, it has been a mixed performance by sterling against the dollar and euro so far this year.

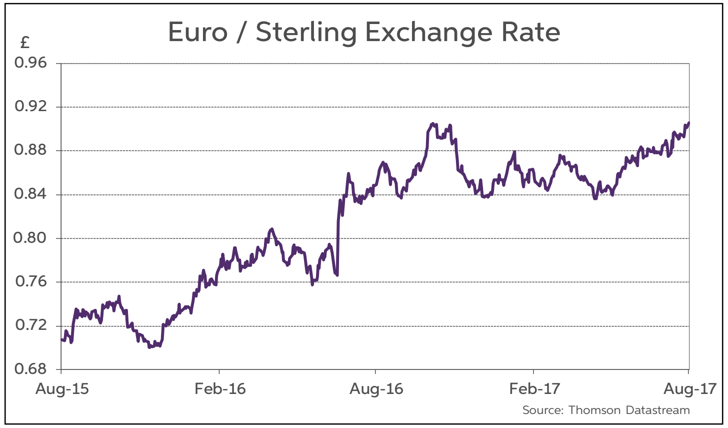
Brexit is likely to be the key factor influencing sterling in the period ahead. The formal exit negotiations between the UK and EU began in late June and are likely to last until the end of next year. The early stages of the Brexit talks are largely technical in nature, dealing with budgetary issues, borders and citizens' rights. Discussions on the more substantive, but difficult, issue of future trade relations, as well as possible transition arrangements that may apply for a period after the UK leaves the EU, are unlikely to commence until later this year or in 2018.

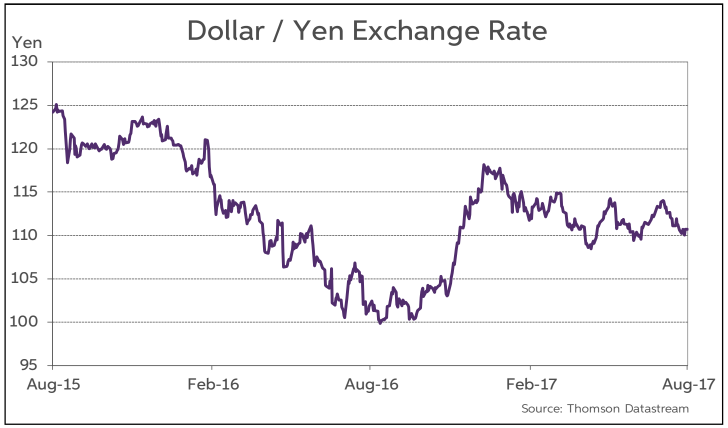
The Brexit negotiations are likely to prove quite difficult, especially as they come to a head next year, when they get to trade and what transition arrangements might be put in place after the UK leaves the EU. The talks could turn quite fraught by that stage and be punctuated by crises, with much uncertainty about the final outcome.

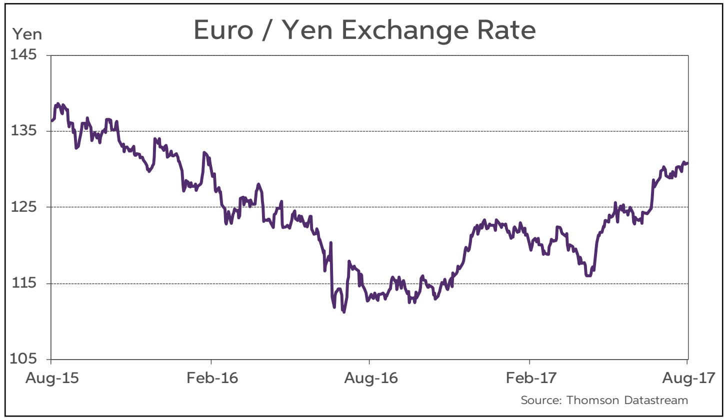
There are growing hopes, though, that the outcome of the talks will be a soft Brexit with transition arrangements agreed that allow for continuing free trade between the UK and EU until a full trade deal is negotiated. The British Chancellor has suggested that the UK could remain an "associate" member of the Customs Union in the transition phase, with the current customs border trading arrangements remaining in place during this period. The fact that the Conservative government has lost its majority in Parliament has also increased the prospect of a soft Brexit, as it will now have to take more cognisance of opposition parties views, who favour such an outcome.

Nonetheless, there is still a risk of a hard Brexit where the UK loses free access to EU markets and has to fall back on WTO rules. This would be very negative for the UK economy and see further falls in sterling. We will have to await the outcome of the Brexit negotiations, probably in late 2018, to see whether the UK manages to retain relatively free access to EU markets or, instead, faces a hard Brexit.

A hard Brexit could see the euro move well above the 90p level, with cable falling towards $1.20. On the other hand, a soft Brexit should see the currency regain much of the ground lost since June 2016, with cable rising back above $1.40 and the euro moving down towards 80p. In the near-term, though, sterling may trade in narrow ranges as it awaits developments in the Brexit talks. The 91p level against the euro hit last autumn may offer some support to the currency. If progress is made on the Brexit talks later this year and the negotiations move on to discussing trade, then sterling may start to recover ground on hopes that a deal for a soft Brexit can be agreed.







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Summary of Exchange Rate Forecasts

("Spot" Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

	Current	Q3-2017	Q4-2017	Q1-2018	Q2-2018
Euro Versus					
USD	1.181	1.15-1.21	1.13-1.19	1.11-1.17	1.10-1.16
GBP	0.908	0.88-0.94	0.86-0.92	0.84-0.90	0.83-0.89
JPY	130.31	128-134	128-134	128-134	128-134
CHF	1.15	1.15	1.15	1.15	1.15
US Dollar Versus					
JPY	110.33	108-114	110-116	112-118	113-119
GBP	1.301	1.27-1.33	1.27-1.33	1.28-1.34	1.28-1.34
CAD	1.27	1.27	1.28	1.29	1.30
AUD	0.79	0.79	0.78	0.77	0.76
NZD	0.73	0.73	0.72	0.71	0.70
CNY	6.70	6.70	6.75	6.80	6.85
Sterling Versus					
JPY	144	144	147	151	152
CAD	1.65	1.65	1.67	1.69	1.71
AUD	1.64	1.65	1.67	1.70	1.72
NZD	1.77	1.78	1.81	1.85	1.87